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Preface

The legal systems of European countries generally provide that loans are fungible: They can be assigned to third parties without the debtor's consent. Ever since post-classical Roman law of the 4th and 5th centuries abandoned the principle of the non-transferability of a claim and recognized the transfer of full rights, this principle has penetrated European legal systems through a wide variety of paths.

However, the principle of the fungibility of claims is only on paper in many legal systems - at least in large parts of the respective economic life. It plays only a minor role in practice in almost all countries of the EU. In reality, there is a glaring market failure because, quite generally, existing market structures affirm the fungibility of loans *de jure* but create and prevent high hurdles *de facto*. This is for three reasons.

First, in some countries, at least in the area of bank loans, there is a cultural understanding that tends to reject the principle of free assignment. According to German philosophy - much more so than in Anglo-Saxon countries - a loan agreement is based on a relationship of trust. The fact that one party to the contract, the bank, can impose a new creditor on the debtor of the loan without the latter's consent seems inappropriate to many observers in Germany. Nevertheless, the German government has strictly defended and upheld the principle of free assignment against manifold opposition. Without this principle, the problems of the financial crisis could not have been solved.

The second reason is a lack of demand. In non-Anglo-Saxon markets, there is practically no willingness to invest in debt sales precisely because of this basic cultural understanding. But: where there is no supply, there is no demand. And: supply creates demand - so that the real question should be: how, in what way can a marketable supply be created?

Finally, thirdly, there are market-related reasons that stand in the way of the fungibility of receivables. Receivables are an economic good that can only be recorded in the abstract. They are defined only and exclusively by contract texts and underlying legal provisions, by nothing else. Since contract texts now look very different, the world of loans is very differentiated, which makes marketability difficult.

It is noteworthy that the EU Commission has addressed these aspects in an important sub-sector. In November 2018, it had issued a review mandate to the European Central Bank to enable more efficient risk transfer, especially for non-performing loans - "NPL"s. This was prompted by the indisputable finding that demand in the market for NPLs is oligopolistically structured and that, as a result, major market distortions have occurred. Moreover, it was generally crucial to enable framework conditions for efficient and safe risk transfer.

Now we are facing major challenges in view of the Corona crisis with renewed lockdown and high infection rates. It is feared that a storm is sweeping across the European banking market. That the fungibility of credit risks is a key factor in coping with such a major crisis should be indisputable.

The authors of this memorandum believe that there is only one sensible solution for a transparent, neutral and publicly controlled way to transfer credit risks: By establishing an electronic trading platform for credit in the form of a public law exchange at the European level.

The platform function could by no means be limited to trading existing loans and bonds. It would also be conceivable to use the platform to establish new credit relationships - for example, for investment loans. The route via the stock exchange is important because a general industry standard can be standardized solely by means of public-law statutory authority. As a result, a hub function based on a shortened, standardized, digital bidding process would be conceivable.

This study deals with these opportunities.

I. Contours of a European Exchange Landscape for Debt Securities

1. The Commission Initiative

The aforementioned Commission initiative of November 2018 on the transfer of credit risks should not be underestimated in its significance. The European Commission thus documents a glaring market failure for an important area of economic life. If one follows it, efficient instruments are urgently needed for the area of NPL loans to enable the transfer of credit risks.

In the meantime, the EBA has also taken a clear stance on this issue. Its President Andrea Enria is strongly in favor of the establishment of a credit platform. The EBA considers the establishment of a platform for the transfer of credit risks to be urgently necessary in order to avert economic damage to the member states.

The undesirable developments that came to light in the years following the financial crisis, particularly in the disposal of troubled loans in the individual markets, can be exemplified by the development of the German market after the 2009 financial crisis. The emergency became clear when the state withdrew piece by piece from its initial aid and intervention measures. Suddenly, debt holders seeking to clean up their balance sheets had to rely exclusively on the private market. Only after the end of state intervention policies did it become apparent how tightly and oligopolistically the demand side of the market for credit risks was structured - and still is today. In view of the volumes traded, only a few financial institutions such as investment banks and hedge funds with the necessary expertise and resources came into question as buyers of credit risks, and they still do today. They are able to determine prices due to the narrowness of the market on the buyer side. The fact that the sales processes themselves are extremely complex plays a role here - as a rule, the data and credit documents are made available to interested parties for inspection and review over a period of several months. The lack of a sufficiently large number of enquirers, the complex procedure and the lack of transparency that was observed led to extraordinarily high discounts on the nominal values of the receivables sold. Added to this were high transformation costs incurred by intermediaries, lawyers and consultants.

2. A Credit Exchange Creates Orderly Conditions for Competitive Markets

The solution to overcome such deficits and to meet the requirements formulated by the EU - Commission for credit risk transfer lies in the establishment of a regulated marketplace, a credit exchange. There are exchanges for securities, foreign exchange, commodities, derivatives, recently for energy and emission rights trading. These are proven institutions for concentrating the trading of fungible commodities in time and place under supervised, transparent pricing. These features are so important and essential that it seems almost inevitable to apply this principle to the transfer of debt securities, i.e. credit risks. In this way, the EU would fulfill an important regulatory task, namely to create stable framework conditions for balancing supply and demand in competitive markets.

3. The Marketplace must be Governed by Public Law and must set market-shaping Industry Standards

In principle, there are only two possible solutions for designing a marketplace in the form of an IT platform that is openly accessible to market participants: a private legal form with private purchasing conditions or an institution under public law with a set of rules governed by statute. Both variants are fundamentally different. Only the public-law rules and regulations of an exchange anchored in European law constitute mandatory (European) law, may not be circumvented or relaxed in individual cases, and are subject to sanctions - e.g., what happens if the information is incorrect? In the former case, this is a matter of negotiation; in the latter case, there is a binding body of public law.

Moreover, private transaction platforms do not create a risk transfer with an in rem effect, but they organize the sale of loans under the law of obligations via an information and data space. The in rem transfer process is carried out behind the scenes between the participants according to their agreements and the private exchange's set of rules under the law of obligations. The transaction itself thus takes place outside the platform.

In the case of an exchange under public law, on the other hand, all transaction modalities are laid down in a sovereign manner by the substantive statutory law as a set of rules. According to this concept, the trading process takes place in such a way that the person of the creditor definitely changes with the acceptance of the bid in the trading room. In this logical second, e.g. in the case of banks, the equity relief for the seller and the equity burden for the buyer is carried out. It is a question of "true sale". This position of the creditor is bankruptcy-proof. There is no time difference between the obligation under the law of obligations and the execution transaction in rem, an important factor in times of nervous market phases.

Finally, the stock exchange's sovereignty under public law in terms of statutes and thus in terms of design enables standardization specifications for all relevant elements of trading operations, i.e. for data, processes, collateral and contracts. Solely and exclusively through a set of rules anchored in public law can the decisive consumer protection elements in credit transactions, such as data and customer protection, fairness rules, and even questions of maturity, enforcement, etc., be regulated with binding effect for and against all market participants. This is the only way to prevent uncontrolled growth, abuse of power and legal positions, and to create the necessary trust to be able to carry out the necessary balance sheet adjustments in the markets.

The advantages of such a system are thus obvious:

- The transfer of risk takes place according to clear rules deposited in the law and the Exchange Rules, which every exchange participant undertakes to observe and which are kept as simple and transparent as possible in the interest of the functioning of this marketplace
- The reliability of the exchange participants - by no means necessarily only banks - is ensured when they are admitted to the exchange, so that a business partner risk is minimized as far as possible.

- The exchange ensures standardization of the products traded on it, so that in this respect extensive homogeneity is ensured and the information costs and risks for suppliers and demanders are reduced. A transparent pricing mechanism, linked to default probabilities, improves risk-adequate pricing and thus promotes the efficient allocation of capital.
- The settlement of transactions via an electronic exchange platform with corresponding volumes will reduce the transaction costs of risk transfer and is ensured in defined processes. Credit processing and ongoing reporting are also carried out in defined transparent processes, which avoids asymmetric information as far as possible. Furthermore, the exchange establishes transparency at all times for all transactions running through the platform.

II. Legal Authority to Establish an Exchange?

An EU institution such as the ECB or the EIB having statutory sovereign powers over a trading platform with exchange functions would indeed have far-reaching consequences. Every legal act of the EU exchange operating body would have the legal quality of EU standards which, as higher-ranking law, would derogate national individual legal provisions. EU law would thus be created, which would apply - albeit only between the parties - in all member states. No private solution would be able to guarantee this Europe-wide standardization of law.

At this point, however, the question arises as to whether EU law provides any legal authority at all for the establishment of a stock exchange supported by a European institution. The answer to this question is in the negative. On the basis of the enumerative principle, the European Treaties do not provide any legal powers for the ECB (cf. Art. 282 TFEU and Protocol on the Statute of the ESCB and of the ECB, Art. 34.1 in conjunction with Art. 3.1, 1st sentence). Art. 3.1, 1st indent) nor for any other EU institution a right to establish and operate a European stock exchange. Therefore, an act of the European legislator would be required. Because of the unanimity requirement, this path is extraordinarily difficult and associated with risks, including time risks, of course. It is therefore only feasible with great difficulty.

However, there is a way to get closer to the goal of establishing a European credit exchange via an interim solution: By setting up a national credit exchange in Luxembourg under Luxembourg law as an identical preliminary stage for a European solution. Legally, this is possible without further ado; via the set of rules under Luxembourg law, every exchange participant, including foreign ones, would be legally bound. The ECB could therefore use the rules and regulations of this exchange for its purchases and thus set its standard throughout Europe. The sheer power of the purchasing volumes of European institutions participating in the market, such as the ECB, and the volume of credit claims at issue would make the standards of the rulebook the norm throughout Europe. This would be a pragmatic step toward legal harmonization in banking, credit and collateral law, without first having to rely on the European legislator.

With such a solution, it could also be considered that the establishment of an exchange platform can also be legally divided into two parts: By establishing an institution that establishes the rules and regulations under sovereign, public law and fulfills the political mandate. And furthermore by establishing a stock corporation, which takes over the administrative processes and thus represents the material stock exchange assets. The construction of the Frankfurt Stock Exchange is the model for this. The advantage of this construction is, for example, that from the first day of business, the member states can directly participate in the joint-stock company, which represents the stock exchange assets, and exert influence.

This model thus in fact presupposes that the ECB controls at least parts of its purchases via the platform - just as the EIB could do with regard to its lending operations. It is not necessary for the ECB to operate the platform itself or to make sales on the platform. However, it should not be unimportant that the seat in Luxembourg could possibly create an organizational and possibly also financial proximity to the EIB.

III. Key Points of the Platform Model

1. Content:

- The subject matter of the marketplace is the trading of the individual loan (or bond). The loan is reflected on the trading platform in its essential parameters. Of course, loan packages can be created, but in each package the individual loan level is made visible. Each individual loan is assigned a rating (PD/LDG), combined with a history. The rating is updated on a regular basis. The collateral level is also reflected, linked in the real estate area with the legally required expert opinion. Granulation options are provided to give smaller investors the opportunity to invest and to increase the liquidity of the exchange.
- Another object of the marketplace is the establishment of (new) credit relationships via the stock exchange. This is done in such a way that an authorized address places a credit demand on the platform and informs credit providers it likes about it or invites them to bid. This is therefore not about trading, but about an abbreviated, efficient, digital bidding process. With the decisive advantage that the content of the credit agreement is specified by the exchange regulations. The route via the stock exchange is therefore important because the contents of the contract can only be standardized via the public-law statutes. And because only through a standardized process flow can market participants generate efficiency advantages. Credit generated in this way is given added value by the fact that it is fungible and can be resold via the platform - again in granulated form.
- The - eminently important - data protection is taken into account by a three-stage presentation of the credit on the platform. At the first level, only anonymous basic information about the loan amount, current balance, industry, region/country, yield and current rating is made available to the willing buyer. The second stage receives a much higher level of information, but the seller's address still remains anonymous.

Only the third stage, which requires a specific, case-related compliance declaration, discloses the borrower and logs the details of access. The public-law nature of the regulations alone guarantees this system without gaps, opens up the possibility of sanctions in the event of violations, and ensures absolute protection of the principle.

- The admission system is of crucial importance for a trading center of this kind. For reasons of customer and data protection, only institutions that are subject to regulatory supervision are admitted as market participants. The fact that the exchange participants must submit to the exchange rules already results from the sovereign character of these rules.
- Technically, the trading process is carried out in such a way that each individual credit intended for trading is mirrored on the system of the exchange platform. The offer can also be made visible only to market participants specified by the seller. The essential parameters of the individual loan are then made tradable in the trading system together with the collateral side.
- With the acceptance of the bid in the trading room, the person of the creditor changes definitively. In this logical second, the equity relief for the seller and burden for the buyer takes place. It is a question of "true sale". From this moment, a logical second, the mirrored position on the platform becomes the original position for the buyer bank. This position of the creditor is bankruptcy-proof. And there is no time difference between the debt obligation transaction and the in rem execution transaction, an important moment in times of nervous market phases.
- Each loan can remain on the platform permanently, if the buyer so wishes. The platform includes all functions of a professional loan management - until default. Unless otherwise desired, the credit is visible only to the holder of the receivable; it is managed in trust only for him. In other words, the credit institution holding the receivable does not relinquish its receivables portfolio, but remains the master of the credit portfolio. The credit institution alone decides whether the individual loan is released for trading or not.
- This is where the multiple function of the platform becomes visible. In addition to the transaction and credit justification function of the platform, another objective must be to ensure that banks which, for example, offer loans to the ECB for purchase do so only via the exchange platform. This means that they are subject to the rules and regulations and, consequently, also to the standardizing legal and process specifications laid down there. This would ensure that these portfolios - standardized according to uniform principles - can be managed efficiently on the platform. Homogenization of loan portfolios would thus be another main function of the platform to enable efficient management of the huge portfolios held in trust.

2. Structurally:

a) The European Level:

The platform has an eminently European dimension. The conceptual core is that a European institution such as ECB, EIB or EBA can take the direction for the establishment of such a trading platform and with this step also define the structure and content of downstream national platforms.

The key role here will be played by the ECB. If the ECB decides to make even its purchases exclusively via the platform in the future, the sheer buying power of the ECB would mean that the public law rules and regulations of such a receivables exchange would shape credit law in all connected countries. For this reason alone, it makes sense to transfer the content-related legal provisions of the rules and regulations to the ECB, even if the ECB itself does not want to be the operator of the platform and does not want to and will not use the platform for sales.

Should such a step go too far for the ECB, partial holdings of the ECB's purchase volume could still be considered, especially in such cases where the ECB wants to influence the contractual content of the loans to be purchased through the rules and regulations of the exchange (because in the rules and regulations, the contracting parties submit to the contractual clauses formulated therein).

Finally, it is conceivable that the EIB could market its extensive loan programs via the credit exchange. By offering its individual loans digitized via the exchange, the purchaser acquires the loan by acceptance of a bid and the loan is then administered on the platform - with the advantage of the fungibility of this loan.

The formal and substantive design power for the platform with connected exchange, that is the core idea, is thus exclusively incumbent on the EU level; this defines the set of rules for the credit exchanges in the EU.

b) The national Level:

Since the individual nations will hardly be willing to transfer their national loan portfolios, for example of NPLs, to a platform of a European institution, it is necessary to set up national credit exchanges under the direction of the national central banks. For this purpose, a copy of the European platform would have to be made available to the individual central banks, which would control and manage these platforms autonomously with an identical set of rules.

The scope of application of these platforms - the aim of the Commission's November 2018 initiative - would primarily be NPLs, but also arrangements in advance of emerging credit threats, i.e. credit transfers in the interbank market. When using such increased fungibility options, granulations, i.e. denominations, would also be possible in particular to broaden buying interest and would be conducive to the liquidity of a marketplace. This is only possible under fair, transparent and neutral conditions via an exchange platform with a uniform set of rules.

c) Access to the Platform for National End Users?

Beyond these applications, any national platform that would be identical to the EU platform in terms of content and would thus comply with the standard applicable throughout Europe could also be expanded as a platform for commercial and private end users. However, in order to ensure neutrality and, above all, internal stability of such an expansion, such a step would only be conceivable under the following narrow conditions:

- On the lending side, only financial institutions would be permitted as players. Moreover, on the demand side, these would be restricted to individual addresses: The person asking for credit decides to whom the request goes. With such a solution, the important buffer function of the banking industry would be preserved in any case. The financial institutions would, of course, have to be subject to the financial supervision of the respective countries.
- Conversely, access to the platform by those seeking credit would also be channeled: According to the concept, access would only be possible via the auditing and tax consulting professions, which would also have to undergo a special licensing procedure.
- If such a model were to come about, it would be a further significant step toward completing the European single market in a key industry. The decisive factor here would be the equality of the platform regulations in all national markets. The multi-currency nature of the platform would ensure that the entire EU area is covered.
- The platform would preferably target long-term credit, secured and unsecured. Here, the options of all credit institutions are fundamentally limited (exception: issuing houses); they are thus dependent on external refinancing options. These can be organized much more efficiently via a platform than via traditional securitizations. This also creates advantages for the consumer.

3. Realization

This concept can be implemented within one year. The reason for this extraordinarily ambitious timetable is that a predecessor model was formally realized in Germany in 2002 - 2009 with the significant involvement of BaFin and its vice president. However, the project at that time failed under the waves of the financial crisis in 2009. It would now be possible to revive it under different circumstances within a reasonable period of time and at reasonable cost. The concept is supported by a consortium called "Platform for Credits - P4C", which is accompanied by partners from three well-known auditing firms (PwC, E&Y, Deloitte). Our recommendation is to ensure the feasibility of the concept by preparing a feasibility study.

IV. A challenge for politics

At its core, the presented model of a marketplace understands it as a "public good" that takes into account public law values in its entire regulatory framework. This is the only way to establish trust in this market.

Second, at the European level, the sheer power of the European institutions participating in the market and the volume of credit claims at stake creates a move toward legal harmonization in banking, credit and collateral law without relying on formal legal harmonization.

Finally: such an exchange would be applicable across countries; compared to all other solutions, it would be simple, transparent, quickly adaptable and, based on uniform standards, of great benefit to market participants and supervisors.

- Hanover, April 2021

About us

P4C (Platform for Credits) is a company whose mission is to build an electronic platform for trading credits. In its basic features, this concept is based on the predecessor model realized in Germany, i.e. approved by the stock exchange and entered the market. Of course, the concept has been modernized in its essential structures and adapted to today's needs.

The legal form of the company is currently that of a BGB (German Civil Code) company, which can be converted at any time into a GmbH (limited liability company) - and if further developed into an AG (stock corporation). The company works in a joint venture with three large, internationally active auditing firms Deloitte, E&Y and PwC, i.e. the companies that were significantly involved in the development of the German predecessor model at the time. There is their clear commitment to enter into a new development. Furthermore, a team of employees is available that was also involved in the development of the predecessor model at the time. Finally, P4C has at its disposal a pool of expertise from renowned scientists, who are supporting the project with regard to essential legal requirements (including those under European law).

P4C itself consists of four people, three of whom had already been significantly involved in the predecessor model. They are driven by the idea that the developed basic concept of a credit trading platform with exchange function must not be lost with regard to its banking, consumer policy and economic dimensions.

The four persons are:

- Paul Gerhard Kopatz, former CEO of RMX AG (predecessor model), previously director of NordLB
- Dr. Johann Rudolf Flesch, former member of the Board of Management of DG-Bank, where he was responsible for finance, accounting, controlling, organization, IT, then partner in the consulting firm RISKBalance, Hamburg, <http://www.dr-flesch.de>
- Dr. Robert Pohlhauen, former CEO of VGH-Versicherungen, next to the state of Lower Saxony the largest shareholder of the old RMX AG
- Kolwja Zimmer, studied mathematics and physics, various senior positions in finance, credit portfolio and transaction management, partner of RISKBalance, Hamburg.

After this group had initially promoted a modernized concept of a credit trading platform to private institutions since 2014, P4C focused on the model of a public-private partnership from 2017 onwards, because only in the case of an exchange function supported by public law is it possible to implement the mandatory essential content of a successful platform, such as data protection and security, neutrality, standardization specifications for data, processes and contracts, equal treatment of all market participants, and sanction reinforcements in the event of violations. In short, it is not possible without control under public law, which is concerned with safeguarding the interests of the general public. In this respect, the ECB's 2018 call for proposals to win a concept for addressing the problem of non-performing loans suited P4C's efforts. P4C is participating in this process in the joint venture with the aforementioned auditing firms.

